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COMPLIANCE CONNECTION

KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

Welcome to the first edition of The Compliance Connection. Each licensee in the mortgage, small loan company, industrial loan company, and check cashing industries will receive a copy of this annual newsletter. Our intent is to be informative and to provide up-to-date information to those licensees we serve.

KRS Chapter 288

PERSONAL PROPERTY INSURANCE

Department examiners have cited numerous violations of KRS 288.560 (1) during regular examinations. Therefore, clarification of this statute appears warranted.

KRS 288.560 (1) states: "A licensee may request a borrower to insure tangible personal property, ***except household goods,*** offered as security for a loan exceeding three hundred dollars ($300) under this chapter against any substantial risk of loss, damage, or destruction ***for an amount not to exceed the actual value of such property*** or the approximate amount of the loan, whichever is greater, . . . [Emphasis added.]"

The Federal Trade Commission's (FTC) definition of "household goods" (16 CFR 444.1 (i)) was adopted by this agency as a guideline and for clarification purposes only, but was never intended to take the place of KRS Chapter 288. Therefore, 16 CFR 444.2 (a) (4) that permits a lien to be taken on household goods, when it constitutes a purchase money interest, does not apply when the loan is made under the Kentucky Consumer Loan Act.

During the examination of consumer finance companies, loan documents are reviewed, including the insurance policies and supporting documents. In order that we may have uniformity in practice, when insurance is written in connection with a loan, the document for listing the personal property must include the value for each individual item and not just a total amount for all items on the listing document.

If the licensee has a security listing of property with a value of more than the amount of the loan, the policy can be written for the total loan amount. Moreover, when the licensee has a security listing of property with a value less than the amount of the loan, the policy cannot be for an amount exceeding the value of the property.

Please note that while the law permits a licensee to request a borrower to insure tangible personal property offered as security for a loan exceeding $300, it specifically excludes household goods. This also applies to furniture, household appliances, etc. taken as security where a purchase money lien applies. The Kentucky Consumer Loan Law, under the provision of KRS 288, does not permit the insuring of items that are defined as household goods. For example, if the total value of the personal property is $2000 and the security included an electric cooking stove and a household vacuum cleaner valued at $450 and $350, respectively, then the amount of insurance that could be written for the remaining non-household goods items would be $1200.

This restriction does not apply to purchase money security interest on conditional sales contracts, provided the insurance was written at the time the contract was signed.

INSIDE

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2000 Legislative Session Changes KRS 288, 291, 294 and 368

The General Assembly passed House Bill 621 during the last session, and the resulting changes to KRS 288 and 291 became law on July 15, 2000, as follows:

- 288.440(1) increases the license fee from $375 to $400, and increases the half-year fee from $187 to $200;
- 288.450(2) increases the investigation fee from $50 to $250;
- 288.533(5) is a new section allowing a licensee to charge a late fee not to exceed 5% of the installment or $10, whichever is greater. Only one (1) charge may be collected for each scheduled installment. ***(This is an alternative to the default charge described in KRS 288.530 (4). The licensee has the option, at the time of collecting the fee, to use the old method or the new method to determine the amount of the charge.);***

(continued on page 3)

HUD OFFICIAL ISSUES POSITION ON "NET BRANCHES"

The following is a recent letter William Apgar, Assistant Secretary for Housing at HUD, sent to all HUD/FHA appproved mortgagees. The letter sets forth HUD's position on "Net Branches."

It has come to the Department's attention that some HUD/FHA approved mortgagees are engaging in prohibited types of "branch office" arrangements. There have been growing numbers of arrangements referred to as "net branches." Some of these are allowable and some are not. This reflects the fact that the industry does not have a universal definition for the term "net branch." Accordingly, this letter provides further guidance and clarification regarding the Department's requirements for branch offices of HUD/FHA approved mortgagees.

The Department has learned that some HUD/FHA approved mortgagees are engaged in the practice of taking on an existing, separate mortgage company or broker as a branch and allowing that separate entity to originate insured mortgages under the approved mortgagee's HUD Mortgagee Number. Some mortgagees refer to this arrangement as a "net branch." This, however, constitutes a prohibited net branch arrangement. The Department has also noted advertisements in trade publications touting such prohibited "net branching" arrangements as a way for independent brokers to originate FHA mortgages without meeting HUD's application and asset requirements.

Paragraph 1-2 of the Mortgagee Approval Handbook 4060.1 Rev-1 specifies that HUD/FHA insured mortgages may only be originated, serviced, purchased, held, or sold by mortgagees that have been approved by HUD/FHA. Approved mortgagees are permitted to conduct such activities from branch offices. However, separate entities may not operate as "branches" of a HUD/FHA approved mortgagee and if the separate entity lacks HUD/FHA approval, its mortgages constitute third party originations which violate Departmental requirements. If the separate entity was purchased and merged into the approved mortgagee in compliance with applicable state law(s), the approved mortgagee must provide a copy of the merger documents and state licenses) to HUD's Lender Approval and Recertification Division, 451 Seventh Street SW, Room B133-P3214, *Washington, DC* 20410.

In contrast to the arrangements described above, another common example of a net branch arrangement is one wherein the branch manager's compensation is based upon the "net" profit of the branch. The HUD/FHA approved mortgagee collects the revenue from the branch, pays the branch expenses, and then pays the branch manager the *remaining revenues*, if any, as a commission. Such an arrangement is, essentially, an alternative compensation program for the branch manager and is an acceptable branch arrangement if all other branch requirements are met.

Paragraph 2-17 of the Mortgagee Approval Handbook 4060.1 Rev-1 requires a HUD/FHA approved mortgagee to pay all of its operating expenses including the compensation of all employees of its main and branch offices. Other operating expenses that must be paid by the HUD/FHA approved mortgagee include, but are not limited to equipment, furniture, office rent, and other similar expenses incurred in operating a mortgage lending business. Thus, the distinction between an acceptable and unacceptable alternative branch compensation plan is not whether the manager's or any other employee's compensation is related to the profits generated by the branch. Rather, it is whether the operating expenses are paid by the HUD/FHA approved mortgagee. If the expenses are paid by the HUD/FHA approved mortgagee, the arrangement is acceptable. If, however, the expenses are paid by the branch manager from a personal or nonmortgagee account (or by some third party), the arrangement is prohibited and a true branch does not exist.

As part of on-site mortgagee monitoring reviews, the Department has obtained "employment" agreements executed by HUD/FHA approved mortgagees and their "net branches." A number of the provisions in these agreements violate Departmental branch requirements. For example, there are provisions that:

- require all contractual relationships with vendors such as leases, telephones, utilities, and advertising to be in the name of the "employee" (branch) and not in the name of the HUD/FHA approved mortgagee.

- require the "employee" (branch) to indemnify the HUD/FHA approved mortgagee if it incurs damages from any apparent, express, or implied agency representation by or through the "employee's" (branch's) actions.

- require the "employee" (branch) to issue a personal check to cover operating expenses if funds are not available from an operating account.

These provisions violate Paragraphs 1-2, 2-13, 2-17, and 3-2B of the Mortgagee Approval Handbook 4060.1 Rev-1. Taken as a whole, such provisions seem designed to maintain a clear separation between the HUD/FHA approved mortgagees and their so-called "branches," which is inconsistent with the close supervisory control over all employees mandated by the handbook.

The Department believes that the origination of insured mortgages by lenders that have not received HUD/FHA approval increases the risk to the FHA insurance funds and to the public. Accordingly, mortgagees found to be in violation may be subject to the full range of HUD sanctions.

Sincerely,

William C. Apgar
Assistant Secretary for Housing
Federal Housing Commissioner

HELPFUL REMINDERS
KRS Chapter 294 Licensees

CHANGE OF CONTROL KRS 294.075 (1)b says: "A transfer of at least ten percent (10%) of the outstanding voting stock of a mortgage loan company or a mortgage loan broker constitutes a change of control. Further KRS 294.075 (2) says: "A transfer of voting stock of a mortgage loan company or mortgage loan broker **which constitutes a change of control** shall be approved in writing by the commissioner, **PRIOR** to the transfer. [Emphasis added.]"

COMPANY NAME KRS 294.070 (3) says: "A mortgage loan company or a mortgage loan broker required to have a license under this chapter **shall not** use the words **bank, trust, national or federal** or any form thereof separately or in a combination thereof with other words or syllables as a part of its name or to otherwise identify itself. [Emphasis added.]"

FEES AND CHARGES KRS 294.120 (6) says: "No person shall receive any fee or other compensation of any kind in connection with procuring any loan, except for services actually rendered . . . " This section of the law permits only the **actual cost** of any third-party settlement service to be passed on to the borrower.

LETTERS OF COMMITMENT KRS 294.129 (7) says: "All letters of commitment or any other contracts or agreements between prospective borrowers and a mortgage loan company or a mortgage loan broker, where the borrowers employ services, for a fee or commission, to obtain a loan commitment or funding from a lending institution shall indicate the terms and conditions thereof, including a full and detailed description of the services the broker or the company undertakes to perform, a specific statement of the circumstances in which the broker or the company will be entitled to obtain or retain consideration, and **the period that such agreement shall remain in effect. [Emphasis added.]"**

KRS Chapter 368

GROWTH IN DEFERRED DEPOSIT INDUSTRY

The deferred deposit industry appears to be a growth industry in the state of Kentucky as the number of licensed locations continues to increase.

As of June 1, 1999, there were 95 separate licensees, several with branches, making a total of 321 licensed locations. As of June 1, 2000, there were 119 separate licensees, 64 of which have one or more license locations, making a total of 385 licensed locations. The Department's policy is to examine each licensed location annually. Fees for the examinations will remain at $42 per hour. The hours billed encompass pre-exam review and planning, travel time, hours at the licensed location, and the outside hours spent writing the report.

The examination procedures established to monitor compliance with KRS 368.010 through KRS 368.120 will remain basically unchanged as no changes were made to the governing statutes during the 2000 legislative session. However, each licensee is reminded that for some time examiners have been cross checking the deferred deposit transactions between branches to ensure that the licensee is appropriately monitoring against over limit violations. This only affects branches that are in close proximity to each other. Close proximity may be deemed up to 50 miles; however, all branches within 30 miles will always be considered to be in close proximity.

HELPFUL REMINDERS

KRS 368.020 says: No person shall engage in the business of cashing checks or accepting deferred deposit transactions for a fee or other considerations without first having obtained a license. **A separate license shall be required for each location from which the business of cashing checks or accepting deferred deposit transactions is conducted.**

KRS 368.080 says: Each license may be renewed for the ensuing twelve (12) months' period upon the payment to the Department annually, on or before July 1 of each year, a license fee of five hundred dollars ($500) for each additional location.

(continued from page 1)

- 288.590 changes the date of the annual report to the Department from April 15 to January 30;
- 288.991(1) increases the penalty for conviction of violating the chapter from a minimum of $1000 to $5000;
- 288.991(2) increases the penalty for willful violation of the chapter to a class A misdemeanor;
- 288.991(3) is a new section specifically allowing the commissioner to refer evidence of violations of the chapter to a prosecuting attorney;
- 288.991(4) is a new section providing that nothing in the chapter limits the power of the state to punish crimes; and
- 288.991(6) is a new section specifically allowing the commissioner to order a refund to customers of fees collected in violation of the chapter and to administratively assess a fine of $1000 to $5000.

Changes to 291

- 291.460(5) allows industrial loan companies to operate revolving credit plans that may be accessed by a credit card, check, or other devise as the plan described;
- 291.460(5) allows a bad-check charge of $15 and an over-the-limit charge of $20 on revolving credit plans;
- 291.530(3) changes the date of the annual report to the Department from January 15 to January 30.

There were no changes to KRS 294 and 368 during the 2000 legislative session.

COMMONLY ASKED QUESTIONS OF HUD & HUD RESPONSE

Q 1. Whether a lender may "markup" a third-party vendor's fees for the purpose of making a profit when no additional services are provided by the lender and thereby disclose the "marked-up" fee on the HUD-1, or whether the lender is limited to charging / disclosing its actual cost in obtaining the service?

A A lender that purchases third-party vendor services for purposes of closing a federally related mortgage loan may not, under RESPA, mark up the third-party vendor fees for purposes of making a profit. HUD has consistently advised that where lenders or others charge consumers marked-up prices for services performed by third-party providers without performing any additional services, such charges constitute "splits of fees" or "unearned fees" in violation of Section 8(b) of RESPA.

Section 8(b) of RESPA provides that "[n]o person shall give and no person shall accept any portion . . . of any charge made or received for the rendering of a real estate settlement service . . . other than for services actually performed." 12 USC 2607(b). The RESPA regulations repeat this prohibition under 24 CFR 3500.14(c), adding that "[a] charge by a person for which no or nominal services are performed . . . is an unearned fee and violates this section." Under these provisions, any settlement service provider that charges a fee as a "mark-up" of a fee for a third party's services in a covered transaction without itself rendering services or furnishing goods in exchange for that portion of the fee would violate RESPA's prohibitions against split or unearned fees.

This has been a long-standing position of HUD and was most recently articulated in a preamble of a final rule issued with a statement of policy on computerized loan origination systems, on June 7, 1996 (61 Fed. Reg.* 29238). That publication states, in part:

> HUD believes that Section 8(b) of the statute and the legislative history make it clear that no person is allowed to receive "any portion" of charges for settlement services, except for services actually performed. This provision of Section 8(b) could apply in a number of situations: (1) where one settlement service provider receives an unearned fee from another provider; (2) where one settlement service provider charges the consumers for third-party services and retains an unearned fee from the papyment received; or (3) where one settlement service provider accepts a portion of a charge (including 100% of the charge) for other than services actually performed. (61 FR 29238,29249).

The HUD-1 and HUD-1A Settlement Statement must reflect the amount actually paid to the third-party service provider (that is, the actual amount of the fee) in compensation for the third-party services. "This is set-forth in the General Instructions to the HUD-1, made applicable in 24 CFR3500.8(b), and found in Appendix A to part 3500, which state that the settlement statement shall "itemize all charges imposed upon the Borrower and the Seller by the Lender . . . and any other charges which either the Borrower or the Seller will pay for at settlement . . . The names of the recipients of the settlement charges in section L . . . should be included in the blank lines. [Emphasis added.]" The instructions for Section L pertaining to settlement charges further clarify that "[f]or all items except for those paid to and retained by the Lender, the name of the person or firm ultimately receiving the payment should be shown." Pursuant to these provisions, charges for third-party services must be separated and specifically itemized.

If the lender charges additional amounts for performing actual services in connection with a particular settlement service purchased from a third party (for example processing and evaluating an applicant's credit report purchased from a third-party credit reporting company), those amounts cannot simply be added to the fee paid to the third-party provider for disclosure purposes. Rather, such charges by lenders for processing or other services must be broken out from the particular third-party fee and specifically identified and disclosed in the line item reserved for processing or origination costs (line 801) or, in accordance with section 3500.9(a)(4), may be inserted in blank spaces.

Q 2. In the context of processing a residential loan application to which RESPA applies and where the lender selects a credit reporting company, does the phrase "the cost of the credit report" (in Regulation X, 24 CFR section 3500, Appendix A, Instructions for HUD-1, line 804) mean the credit reporting company's charge to the lender?

A Yes. Pursuant to HUD's Response to Question 1, the actual fees paid to third-party settlement service providers for goods furnished or services actually provided must be disclosed and separated from any charges imposed by the lender.